SUPREME COURT, U. S.

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IN THE

Supreme Court of the United States

October Term, 1973
No. 73-1137

AMERICAN FIDELITY FIRE INSURANCE COMPANY, a New York corporation,

Petitioner,

vs.

STATE BOARD OF EQUALIZATION OF THE STATE OF CALIFORNIA,

Respondent.

RESPONDENT'S OPPOSING BRIEF

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STATE BOARD OF EQUALIZATION OF THE STATE OF CALIFORNIA,

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RESPONDENT'S OPPOSING BRIEF

The petitioner has petitioned this Honorable Court for a Writ of Certiorari to the California Court of Appeals, after decision in that court (*American Fidelity Fire Insurance Company v. State Board of Equalization,* 34 Cal. App. 3d 51 (1973)). The only issue of constitutional law presented in the appeal in California was that of due process under the federal constitution in the imposition of liability for penalties along with the tax and interest against sureties of delinquent sales taxpayers. Each of the particular assertions of unconstitutionality of the sales and use tax law and its administration was answered by the decision of the Court of Appeal in holding that no notice to the surety is required in order to impose liability for tax, interest and penalties. The District Court of Appeal held that petitioner's theories of unconstitutionality were without

merit. It is respectfully submitted that the opinion of the Court of Appeal correctly disposes of the constitutional issues involved in this case so that there is no necessity for a writ of certiorari to the United States Supreme Court. There is absolutely no inconsistency between the opinion of the Court of Appeal and any other decision of California or the United States.

Questions as Presented by Petitioner

1. Whether Amendments V and XIV of the Constitution of the United States require that a state, prior to assessing tax penalties, against the taxpayer's surety for the default of the taxpayer, must give notice to the surety of the amount due before assessing additional sums in the form of penalties against the taxpayer's surety.

2. Whether the assessment of tax penalties against the taxpayer may be imputed to the surety absent notice of the impending default of the principal to the surety.

ARGUMENT

CALIFORNIA TAX COLLECTION PRACTICES AND PROCEDURES COMPLY WITH MODERN FEDERAL DOCTRINES WHICH CONSTRUE THE REQUIREMENTS OF DUE PROCESS

A. Petitioner Erroneously Sets Forth the Tax Collection Procedures of the Board of Equalization of the State of California in Presenting Its Question to This Honorable Court

Petitioner is correct when it states that when the Board of Equalization determines that the taxpayer owes additional taxes a determination thereof is sent to the taxpayer and that the determination becomes final after 30 days unless the taxpayer formally contests the determination. However, petitioner errs when it states that all statutory penalties which are the subject of these proceedings accrue at that time. Petitioner also errs when it states that if the taxes and interest set forth in the determination were timely paid, the penalty provisions would be inapplicable. This language erroneously implies that all the penalties involved under the Sales and Use Tax Law in the State of California accrue at the end of the 30-day period following the notice of determination sent to the taxpayer. This is incorrect.

The notice of determination sent to a taxpayer, in almost all instances after an audit of the taxpayer's books and records has been completed, indicates that a 10% penalty will be due if the amount of the determination is not paid within a thirty-day period as provided by the law. That penalty attaches or accrues or is incurred at the end of the period by reason of the failure to pay the determination. However, other

penalties that may be included in the amount of the determination, such as for failure to file returns or for negligence or for fraud have previously attached or accrued or been incurred by reason of prior acts or failure to act on the part of the taxpayer. Also, if a return in the proper amount is paid late, a penalty will have attached or accrued or been incurred at the time the tax was due and no determination would be issued at all. In all of these cases the penalty accrues before the board has any reason to assume it will accrue. It would not be reasonable to require the Board to send notice to the surety in advance of each time that a penalty might be incurred depending upon actions that may or may not be taken by the taxpayer. That would require notice to the surety each time a determination is issued and prior to the end of each reporting period, quarterly or monthly or annually for which a tax must be paid.

Hence, under the law of California, the only penalty that could possibly be avoided by payment within the thirty-day period following a notice of determination is the ten percent penalty under section 6565 of the Revenue and Taxation Code for failure to pay the amount of the determination by the end of the period. Again, this is only in the rare instance when a taxpayer has been audited, not in the normal case where a return has been filed and the taxpayer has failed to pay. Such payment would not avoid any penalties included in the amount of the determination, such as those for failure to file, negligence or fraud. These latter penalties are the ones for the most part which American Fidelity sought in its refund action and refused to pay so as to require the counter-suit by the Board. The petition merely sets forth arguments directed toward the

failure to pay a determination penalty under section 6565. None of the arguments set forth in the petition would apply to the penalties incurred for failure to file returns, negligence or fraud, or failure to pay prior to a determination. In general, the surety argues it should have notice that the taxpayer has failed to pay his taxes and is about to be charged with a penalty. But all of the penalties are incurred by some act or omission on the part of the taxpayer which the Board cannot foresee and they are not curable by payment after they are incurred. A notice of determination, when issued, is essentially notice to the taxpayer that the Board has found that the penalties along with the tax and interest have been incurred.

Even in the instance where a deficiency determination has been sent to the taxpayer, there is no reason to assume a taxpayer will fail to pay a deficiency inasmuch as the taxpayer has known of the audit and is probably well aware of the fact that additional tax will be owed. It would be unduly burdensome for the Board to require it to notify sureties that the taxpayer owed more tax than was stated on his return. It would also be inappropriate.

B. Section 6701 of the Revenue and Taxation Code Is Constitutional

American Fidelity admitted that it had the obligation under section 6701 of the Revenue and Taxation Code and its contract to pay all amounts including penalties due on the bonds, however, American Fidelity claimed that the obligation to pay penalties is unconstitutional under the Fourteenth Amendment of the United States Constitution, unless there is proper demand and notice of the default of the principal under

the provisions of section 2808 of the California Civil Code. (App. Op. Br. pp. 27-38.) On the contrary, the surety obligation under section 6701 of the Revenue and Taxation Code is no different than an ordinary surety liability which never requires notice of default on an unconditional bond.

Penalties are incurred immediately on the failure to make timely payments or returns and if due to fraud the penalties are more severe. There may be relief from some penalties for reasonable cause, however, when incurred the penalty becomes a part of the tax. Thus, there are no separate surety law requirements of the tax, interest and penalty. The security bonds in this case in compliance with section 6701 are absolute and unconditional obligations. Under section 2807 of the California Civil Code the surety is liable to the creditor immediately upon the default of the principal, and without demand or notice. Section 2808 is inapplicable to the state because that section applies only to conditional obligations and furthermore the state cannot be held to notice unless the statute upon which the bond is based specifically provides for notice. The statute becomes a part of the bond.

Notice of default would serve no useful purpose because the state has no more knowledge than the surety at the time the penalty is incurred and notice of default would permit no protective, remedial action by the surety. Immediate notice of default would constitute a burden upon the state without any benefit to the surety. The state as a matter of practice provides sufficient notice of default when the demand is made. American Fidelity has not shown any treatment by the state which differs from the treatment that the law

provides for all sureties by creditors and thus any claim of unconstitutionality fails for lack of factual support.

Similarly, American Fidelity's claim that section 6701 constitutes the improper delegation of a state's duty which is penal in nature is without factual support. There is no delegation of duty but rather the collection of a tax including the penalty which is not a state penal function.

1. Penalties Are Part of the Tax and Cannot Be Segregated for Different Treatment Under the Law

It is well settled in California that a penalty which is created by statute for failure to pay tax assessment becomes part of the tax. *Sonleitner v. Superior Court*, 158 Cal. App. 2d 258 (1958) (and cases cited therein).

Penalties in exact percentages are provided for late prepayment (sections 6476, 6477, 6478), late payments (section 6591), negligent and fraudulent deficiencies of payments (sections 6484 and 6485), and failure and fraudulent failure to file a return (sections 6511 and 6514). There is no discretion in the amount of a penalty. If the board finds that a person's failure to make a timely return or payment is due to reasonable cause and circumstances beyond the person's control and occurred notwithstanding the exercise of ordinary care and the absence of wilful neglect, the person may be relieved of the penalty provided by sections 6476, 6477, 6511, and 6591 (section 6592). Provision is made for notice and hearing (sections 6561-6566). The regulations in regard to penalties are found in Regulation 1703, 18 California Administrative Code, section 1703.

As can be readily seen from these provisions, penalties are incurred immediately on the failure to make timely or adequate payment or file returns, and notice of default immediately thereafter would carry no advantage to the surety on the bond provided pursuant to section 6701. Notice of default would serve no useful purpose because the state has no more knowledge than the surety at the time that penalties are incurred and default cannot be anticipated. Immediate notice of default would constitute an undue burden upon the state without any benefit to the surety.

2. Demand and Notice of Default Are Not Required for the Bonds Under Section 6701

A suretyship obligation may be either absolute or conditional. An absolute guarantee is an unqualified undertaking that if the debtor fails in performance the guarantor will perform, whereas a conditional guarantee contemplates, before the guarantor is liable on the contract, the happening of some contingency such as exhaustion of remedies against the principal debtor, exhaustion of other security, procurement of a particular fund, immediate suit on default of the debtor, *demand and notice,* or an accounting. 46 Cal.Jur.2d, § 13, pages 204-05. A suretyship obligation is to be deemed unconditional unless its terms impart some condition precedent to the liability of the surety. Civ. Code § 2806; *Standard Oil Co. v. Houser,* 101 Cal. App. 2d 480, 487 (1950).

The general rule is that the liability of a surety (in the absence of a different contractual provision) accrues at the same time as that of the principal or upon default of the principal. A surety who has assumed liability for payment or performance is liable to the

creditor immediately upon the default of the principal and without demand or notice. *Bloom v. Bender,* 48 Cal. 2d 793, 799 (1957) (citing Civ. Code § 2807; *Somers v. United States F. & G. Co.,* 191 Cal. 542, 546 (1923).) In the latter case the bond language was analogous to the bonds in the instant case.

When an instrument signed by the guarantor is not a conditional or qualified guaranty, the guarantor's argument to that effect and citations relating to such a guaranty are not pertinent. *Standard Oil Co. v. Houser, supra,* 101 Cal. App. 2d 480, 489 (1950).

The state is a special entity not to be bound by notice restrictions unless such a legislative intent clearly appears. *State of California ex rel. Dept. of Employment v. General Ins. Co.,* 13 Cal. App. 3d 853, 858, 861 (1970). The terms of a statute dealing with official bonds fixing the obligation of the surety within the penal sums specified are read into the bond and become a part of it. *Hartford Acc. Etc. Co. v. City of Tulare,* 30 Cal. 2d 832, 837 (1947). Section 6701 does not provide for notice of any kind by the State Board of Equalization prior to an action on the security.

The State Board of Equalization in the instant case has made demand upon surety American Fidelity in each instance wherein the taxpayer has failed to fulfill his obligations to the Board. This demand for payment is sufficient notice of default. The Board cannot give more timely notice because the Board has no notice itself of circumstances which would justify a penalty until after payments or prepayments are delinquent or quarterly returns have been filed or where the taxpayer has failed to file such a return.

American Fidelity appears to suggest that notice is required at the moment the tax is due to give the surety

an opportunity to avoid the penalty by itself paying the tax. The suggestion is unsound. Even if it were possible, which it is not, it would be an unreasonable burden on the Board. It is unreasonable to ask the Board to somehow anticipate default by late return, late payment, negligence or fraud. In all such cases the Legislature would have been influenced by the hardship on the state of immediate notice of default and the utter futility of such notice as a condition precedent to liability on a bond. *See State of California ex rel. Dept. of Employment v. General Ins. Co., supra,* 13 Cal. App. 3d 853, 861-62 (1970). American Fidelity has therefore not shown any treatment by the state which is unfair or which differs from the treatment that the law provides for all sureties by creditors and thus any claim of unconstitutionality fails for lack of factual support.

Provision is made for notice and hearing on determinations of tax and penalties in order to allow the taxpayer to establish that the amounts are not due under the provisions of the Sales and Use Tax Law (sections 6561-66). These sections do not require notice to the surety. Section 6592 provides that relief from penalty is allowed if the board finds that a person's failure to make a timely return or payment is due to reasonable cause and circumstances beyond a person's control and occurred notwithstanding the exercise of ordinary care and the absence of wilful neglect. This section gives the taxpayer the opportunity to file a statement under penalty of perjury setting forth the facts upon which the taxpayer bases his claim for relief.

Under said circumstances, the taxpayer has received a hearing after notice of the determination.

Due process, as it has evolved with respect to taxes, has been described in the following terms:

> "It may be stated as a general rule that the due process clause of the federal Constitution is satisfied in matters of taxation if, at some stage before a tax becomes irrevocably fixed the *taxpayer* is given the right, of which he shall have notice, to contest the validity or amount of the tax before a board or tribunal provided for that purpose. [Citations.]" *People v. Sonleitner,* 185 Cal. App. 2d 350, 356. Italics added.

It has been held that notice and hearing to the taxpayer is not constitutionally compelled when the tax is self-assessed, as are income and sales taxes. *Greene v. Franchise Tax Board,* 27 Cal. App. 3d 38, 43. *Greene* relied upon *Randall v. Franchise Tax Board of State of California,* 453 F. 2d 381, 382 (9th Cir. 1971) wherein it was held:

> "We do not think Sniadach v. Family Finance Corp., 1969, 395 U.S. 337, 89 S. Ct. 1820, 23 L.Ed.2d 349, upon which appellant relies, requires a different result. That case dealt with prejudgment wage garnishment, levied without any notice to the debtor. The procedure here is more like postjudgment execution. Appellant had assessed his own liability and has never claimed that he does not owe the tax. Moreover, he was twice notified of his delinquency and never responded to either notice."

Randall in turn relied upon *Aronoff v. Franchise Tax Board of State of California*, 348 F. 2d 9, 11 (9th Cir. 1965) wherein it was held:

> "It has consistently been held, without a single instance of deviation, that the refund action provided by California Personal Income Tax Law is a 'plain, speedy and efficient remedy' such as to invoke the restraints of 28 U.S.C. § 1341. The Supreme Court opinion in Matthews v. Rogers, 284 U.S. 521, 52 S.Ct. 217, 76 L.Ed. 447 (1932), was the first of a long series of cases to illumine the need, implicitly recognized in § 1341, for state independence in state fiscal matters."

Plaintiff undertakes, for a consideration which is a substantial percentage of the bond, to guarantee the payments due the state. In each case included in the factual stipulation, the amount of the bond written exceeded the total liability incurred by the taxpayer, including principal, interest and penalties. Thus, lack of notice did not result in the surety being required to pay more than it had originally obligated itself to pay. We submit that there is no constitutional compulsion for the Board to give duplicate notice to the surety; its obligation is fulfilled by notice to the taxpayer of the delinquency.

3. There Is No Violation of Due Process or Equal Protection in Requiring Surety for Penalties

American Fidelity contends at pages 11 to 12 that the transfer of the penalties for late payment from the principal to the surety is an arbitrary misuse of the state's police power. It contends at pages 12 and 15 to 22 that the penalties are intended to punish delinquent behavior, that the procedure which imposes liability for penalties upon the surety is contrary to any reason-

able legislative purpose, and that the transfer of penalties deprives the surety companies of fundamental due process protections provided by the United States Constitution against arbitrary state punishment. These contentions were not pleaded in the complaint, nor were these questions among any of the issues set forth in the statement of issues, contentions, and itemization of damages which was incorporated in the pretrial conference order.

There having been no facts alleged in the complaint to support these claims and no mention of these issues in the pretrial conference order, the trial court had no such issues properly before it. *City of Los Angeles v. County of Mono,* 51 Cal. 2d 843, 847 (1959); *Thompson v. Guyer-Hays,* 207 Cal. App. 2d 366, 372 (1962).

In any event, penalties are reasonably imposed under the Revenue and Taxation Code for delinquency and become a part of the tax. *Sonleitner v. Superior Court, supra,* 158 Cal. App. 2d 258 (1958). It is not improper for the State of California to obtain security for the payment of its taxes lawfully imposed. Surety bonds as a form of security based upon liability for delinquent behavior and including penalties are valid.

American Fidelity has cited absolutely no authority that the exaction of penalties for delinquency on tax obligations is the imposition of punishment for a crime, or that a state may not require security against the payment of penalties imposed for delinquency which become a part of the tax itself. It is merely a bald assertion. In the absence of authority to the contrary, it would seem reasonable that the legislation authorizing security is constitutional in order to maintain the fiscal integrity of the state.

Legislative enactments dealing with economic problems usually involve complex, technical and practical considerations which the legislative process is designed to resolve. Therefore, in order for the Legislature to function properly, the courts have given the Legislature considerable latitude in setting up classifications dealing with taxes and economic problems. Legislative determinations of these areas should be conclusive upon the courts unless totally without justification. *Ferguson v. Skrupa*, 372 U.S. 726, 732 (1963); *Railway Express v. New York*, 336 U.S. 106 (1949); *West Coast Hotel Co. v. Parrish*, 300 U.S. 379, 398 (1937); *Lindsley v. Natural Carbonic Gas Co.*, 220 U.S. 61, 78 (1911).

Classifications are valid if they have some reasonable basis. Nor is a classification unreasonable because it results in some inequity. *Dandridge v. Williams*, 397 U.S. 471, 485 (1970). Under both United States and California law classification is permitted. Only if a classification is plainly arbitrary will it be set aside, otherwise it will be presumed valid. If any state of facts supports the classification, Equal Protection is served. *Associated Home Builders etc., Inc. v. City of Newark*, 18 Cal. App. 3d 107, 109 (1971); *Zuckerman-Mandeville, Inc. v. Sheffield*, 8 Cal. App. 3d 793, 799 (1970); *Romero v. Hodgson*, 319 F. Supp. 1201 (1970), *aff'd* 403 U.S. 901 (1971).

The leading case here is *Carmichael v. Southern Coal Co.*, 301 U.S. 495 (1937), which upheld the classifications created by State Unemployment Com-

pensation statutes which conformed with the federal plan. In *Carmichael,* the United States Supreme Court stated on pages 509-10:

> "It is inherent in the exercise of the power to tax that a state be free to select the subjects of taxation and to grant exemptions. Neither due process nor equal protection imposes upon a state any rigid rule of equality of taxation. [Citations.] This Court has repeatedly held that inequalities which result from a singling out of one particular class for taxation or exemption, infringe no constitutional limitation. [Citations.]
>
> "Like considerations govern exemptions from the operation of a tax imposed on the members of a class. A legislature is not bound to tax every member of a class or none. It may make distinctions of degree having a rational basis, and when subjected to judicial scrutiny they must be presumed to rest on that basis if there is any conceivable state of facts which would support it. [Citations.]
>
> "This restriction upon the judicial function, in passing on the constitutionality of statutes, is not artificial or irrational. A state legislature, in the enactment of laws, has the widest possible latitude within the limits of the Constitution. In the nature of the case it cannot record a complete catalog of the considerations which move its members to enact laws. In the absence of such a record courts cannot assume that its action is capricious, or that, with its informed acquaintance with local conditions to which the legislation is to be applied, it was not aware of facts which afford reasonable basis for its action. Only by faith-

ful adherence to this guiding principle of judicial review of legislation is it possible to preserve to the legislative branch its rightful independence and its ability to function."

Many cases since *Carmichael* have reaffirmed the standard applied in *Carmichael* in situations involving economic issues. We submit that under the case of *Dandridge v. Williams, supra,* 397 U.S. 471, 485 (1970), the constitutionality of the bonding statutes of the Revenue and Taxation Code is to be tested by the "reasonable basis" rule traditionally applied to economic and social legislation. *Lindsley v. Natural Carbonic Gas Co., supra,* 220 U.S. 61, 78 (1911), rather than the "compelling interest" test recently applied in *Shapiro v. Thompson,* 394 U.S. 618 (1969), to strike down state welfare residency requirements.

Under the reasonable basis test as applied in *Carmichael* and recently affirmed in *Dandridge,* as well as our California cases cited above, the parties attacking the statutory classification have the burden of showing that the challenged classification does not rest upon any reasonable basis, but is essentially arbitrary. As shown in the cases cited, *supra,* the possible, rational bases which respondents must show to be lacking as to the requirement that the bond cover penalties are not just those that were actually considered by the legislature at the time of enactment, but also any such rational basis which may be conceived to support the classification. *Dandridge v. Williams, supra,* 397 U.S. 485 (1970); *Allied Stores of Ohio v. Bowers,* 358 U.S. 528 (1959); *Carmichael v. Southern Coal Co., supra,* 301 U.S. 509 (1937); *Lindsley v. Natural Carbonic Gas Co., supra,* 220 U.S. 78 (1911). As was

said in *Flemming v. Nestor*, 363 U.S. 603, 612 (1960), "For these purposes, it is, of course, constitutionally irrelevant whether this reasoning in fact underlay the legislative decisions, . . ."

American Fidelity has failed to satisfy the admittedly and justifiably high standard of proof which is required of those who would have this court invalidate legislation passed by the elected legislature.

It was within the power of the legislature so as to insure the efficient collection of sales and use tax to provide that retailers be required to post security for tax, interest *and penalties* in order to encourage compliance with the law and protect the revenue sources of the State of California. American Fidelity erroneously asserts that the State Board of Equalization rather than the legislature requires a bond for penalties. (App. Op. Br. p. 18.) Section 6701 clearly provides for security to recover tax, interest *and penalty*. If surety companies wish to engage in the business of providing the necessary security, they cannot complain of coming within the classification of a surety of sales and use taxes including tax, interest and penalties. It must be remembered that the administrative convenience of collecting sales and use tax through the security statutes is a justifiable reason for these statutes. *Carmichael v. Southern Coal Co., supra,* 301 U.S. 495, 511 (1937), is a case in point where it was held:

> "Administrative convenience and expense in the collection or measurement of the tax are alone a sufficient justification for the difference between the treatment of small incomes or small taxpayers and that meted out to others. [Citations.] We cannot say that the expense and inconvenience of collecting the tax from small employers would not be disproportionate to the revenue obtained. . . ."

In the earlier case of *Burnet v. Wells,* 289 U.S. 670, 678 (1933), the court said:

> ". . . Even administrative convenience, the practical necessities of an efficient system of taxation, will have heed and recognition within reasonable limits. . . ."

In the recent case *Schilb v. Kuebel,* 404 U.S. 357, 369 (1971), it was recognized that administrative convenience can form a reasonable basis for a classification.

Conclusion

This concludes the response to the petition in the instant case. Respondent believes that when the record is examined relative to the matter claimed of, and the opinion of the California Court of Appeal considered, it will be concluded by this Honorable Court that no right guaranteed by the Constitution of the United States was violated, and that the judgment should stand. Accordingly, respondent submits the matter on the record heretofore presented to this Court, the opinion of the California Court of Appeal and the arguments set forth above, and requests that the relief asked by this petitioner be denied.

Respectfully submitted,

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